

November 15, 2005

Talking Points

There was a long line of people wrapped around the corner of New York's [hundred-year-old granite Custom House](#) at the foot of Broadway one Friday last month. Most of the people in it had little more than cheap black convenience-store umbrellas to protect them from a torrential downpour. But they had good reason to wait for hours in the driving rain. The following Monday, October 17, a much-disputed [new federal bankruptcy law](#) took effect.

[Similar scenes played out across the country.](#)

People living on the economic brink rushed to declare themselves insolvent under the old law, rather than become guinea pigs of the new regime. A surge in filings in the run-up to the deadline was expected, but the sheer quantity that gray Friday dwarfed most expectations.

The new law makes it much harder for people in financial distress to make the "fresh start" that has long been the promise of American bankruptcy law. It requires most people who earn more than the median income in their state to pay off their debts on [a five-year repayment plan](#). Poorer filers can still avail themselves of [Chapter 7's debt-erasing provisions](#), but they face an array of new hurdles, including mandatory credit counseling, greater paperwork requirements, and rising lawyers' fees.

America has always been ambivalent about bankruptcy. It has been stigmatized as a refusal to make good on one's obligations. But at the same time, the laws governing bankruptcy have been credited with contributing to the flexibility of the



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business issues.

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Readers are invited to respond to Mr. Kulish with their thoughts on the new bankruptcy regulations.

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Graphics

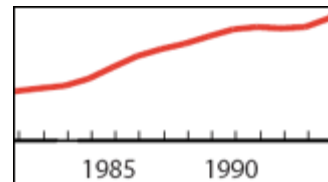
American economic system, and has been a key ingredient in its success over the last century.

News stories about the new law have largely focused on how it will make life more difficult for people on the economic margins, including those who ended up there as a result of illness, divorce, or other life crises. That focus is understandable - the changes will have a devastating impact on many of the most vulnerable Americans. What is less understood, however, is how the new law could hurt the entire United States economy, and consequently, the financial wellbeing of all Americans.

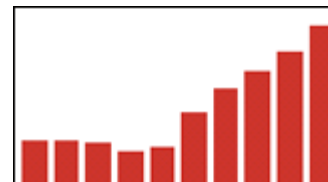
The traditionally more lenient approach in past laws to the discharge of debt was not primarily intended to make life easier for the poorest Americans. It was designed to help create the kind of risk-taking, dynamic economy that has been critical to America's success. But the new rules could well chip away at two of the main pillars of the American economy - the entrepreneurial spirit of small businesses, and robust consumer spending.

While the bankruptcy regulations that apply to big businesses were left pretty much the same, the new law is likely to cause hardships beyond those of individual filers by putting a damper on small businesses. Unlike large corporations, small businesses are often established and financed by their owners, with money from their own bank accounts. As a result, people whose enterprise fails often file for personal bankruptcy. The new law is likely to inhibit them.

The clear winners are the credit card companies and other lenders who pushed the law through Congress. The losers, though, are not just the poor people who will have more trouble declaring bankruptcy. We may all be worse off because of the way in which the new law weakens American economic life.



A Growing Debt Burden



A Steady Rise in Personal Bankruptcies

Additional Reading

[Details on the 2005 Bankruptcy Law](#)
(findlaw.com)

[Information on Approved Credit Counseling Agencies](#) Department of Justice

['Bankruptcy Law Is Criticized for Creditors' Role in Counseling'](#) by Eric Dash and Jennifer Bayot

['The Myth of the Disappearing Business Bankruptcy'](#) by Robert M. Lawless and Elizabeth Warren (kauffman.org)

['Debt's Dominion: A History of Bankruptcy Law in America'](#) by David A. Skeel, Jr.

I. The Blame Game: Reckless Spenders vs. Victims of Circumstance

Personal bankruptcy filings have increased sharply in recent years, more than doubling between 1994 and 2003, when [they reached 1.6 million](#). There has long been agreement that something had to be done, but creditor and debtor interest groups differed sharply over why bankruptcies were soaring, and how to respond.

Public policy debates often produce stock characters that aim to cut through the statistics and complexities - like the welfare queen, living the high life on government largesse. Both sides of the consumer bankruptcy debate have their preferred symbol.

Supporters of tougher restrictions conjured up the image of the luxury-loving overspender, living beyond his means, with a flat-screen television at home and a Porsche Carrera in the driveway. Just when the creditors begin snapping at his heels, the deadbeat hides behind consumer-friendly bankruptcy laws, shielding his ill-gotten gains while ordinary suckers - the ones who pay their bills - absorb the cost of his irresponsibility.

Consumer advocates, on the other hand, paint the picture of a poor, honest family, barely scraping by with both parents working, who then suffer an unavoidable setback, such as the loss of a job or a sudden illness. Bankruptcy is the only salvation for these hardworking victims of circumstance, the argument goes, and the new law condemns them to permanent debt slavery.

There are, of course, examples of both. But the statistics show that there are many more hard-luck cases than footloose overspenders.

In the end, this debate was resolved not by the power of either side's arguments, but by Capitol

['Republic of Debtors: Bankruptcy in the Age of American Independence'](#)
by [Bruce H. Mann](#)

['Credit Card Nation'](#) by
[Robert D. Manning](#)

['The Two-Income Trap'](#)
by [Elizabeth Warren](#) and
[Amelia Warren Tyagi](#)

['When All Else Fails: Government as the Ultimate Risk Manager'](#)
by [David A. Moss](#)

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Hill politics. The financial services industry, one of the nation's biggest campaign contributors, persuaded Congress to enact a law that was a virtual industry wish list. The lawmakers ignored the concerns raised by consumer groups, who wanted the law to address the lenders' role in the debt crisis - the explosion of credit-card offerings to poor people, students, and others who are likely to end up with bills they cannot pay, and the outrageous level of [interest levied by many credit card companies](#).

The lenders have tried to frame bankruptcy purely as a story of irresponsible borrowers. But in many cases, it is the creditors who have been irresponsible, by lending money to people they have reason to know may be unable to pay the money back. In the name of holding debtors more accountable, lenders asked the federal government to let them off the hook for their own bad lending decisions.

Neither borrowers nor lenders are, as a group, entirely without blame when debts go unpaid. But of the two groups, the lenders - who are almost invariably large banks and credit card companies - are in a better position to absorb the loss, since they can spread it over many borrowers. Individuals don't have that luxury. When deciding where to place the burden of a bankruptcy law, Congress should have given the benefit of the doubt to vulnerable individuals.

II. The All-American Second Chance

The United States may be far less charitable than European countries when it comes to social welfare programs like health insurance and unemployment benefits, but it has long been generous in giving debtors a second chance.

Bankruptcy is a legal status that in America must be determined by a judge. In Chapter 7 or so-called

"fresh start" cases, once bankruptcy is declared, the debtor's remaining assets and all but a few, exempted possessions are divided up among creditors. But any remaining debts are discharged and do not have to be paid back in the future.

Bankruptcy laws were not always so forgiving. In Roman times a debtor could be sold into slavery and the selling price divided among his creditors. In extreme cases, the debtor could literally be chopped into pieces for divvying up among the same group. England's debtors' prisons were only slightly more humane.

Treating debtors punitively can be cruel to the individuals involved, as those unlucky Romans might have pointed out, but it is also harmful to society as a whole. In our own system, tough bankruptcy measures can discourage people from taking the sort of financial risks that lead to innovation and economic growth. And even those in relatively stable enterprises could be driven out of business by harsh economic climates. American legislators recognized long ago that some measure of protection would benefit the economy.

In 1841, the United States passed its first bankruptcy law that allowed debtors to declare bankruptcy on their own initiative, rather than because their creditors demanded it. [Congressman Eugenius Nisbet](#) of Georgia said at the time, "The public will be the great gainers by discharging the bankrupts, because thereby you throw into activity a large amount of intellectual and professional capital which otherwise would be forever lost." In other words, don't leave the best and brightest on the sidelines just because they got burned in a market collapse or an economic downturn.

Since that 1841 law, America has gone even further to establish a system that gives businesses and individuals leeway to fail. "This country has long had the most debtor friendly of bankruptcy laws,

designed to promote entrepreneurship and innovation, and it worries me that we're moving away from that tradition," says [David Moss](#), a professor at Harvard Business School. "Generous bankruptcy laws encourage us to take risks, and this is a country that does well on risk taking."

III. Message to Entrepreneurs : Don't Take the Plunge

When most people think of American business, they think of Fortune 500 companies and other behemoths. But small, entrepreneurial businesses also help drive the American economy.

[According to the Small Business Administration](#), small companies provide roughly three-quarters of the net new jobs added to the economy and employ half of the private workforce. Of course, not all small companies stay small. American business history is full of stories like that of Stanford graduates [Bill Hewlett](#) and [Dave Packard](#), who founded Hewlett-Packard in 1939 out of a Palo Alto garage, or Ray Kroc, who transformed a single hamburger restaurant owned by the McDonald brothers into a global phenomenon.

These once-small businesses, and many others, were the result of a leap of faith on the part of their founders. It is far less of a hassle to work for a big company, and certainly less of a risk. It takes a particular kind of personality to sink one's life savings into a venture that statistics have proven will most likely fail. In 2004, about 581,000 new firms were founded and 576,000 closed.

This entrepreneurial spirit has long been part of the American economic ideal. And bankruptcy has long been a safety net for entrepreneurs. According to government statistics, there were about 37,000 business bankruptcies in 2003. But [a recent study](#) by bankruptcy experts [Elizabeth Warren](#) of Harvard and [Robert Lawless](#) of the University of Nevada-

Las Vegas estimated the actual number at between 260,000 and 315,000 bankruptcies annually.

Lawless calls the government numbers "divorced from reality," in a release accompanying the study.

The government figure does not include the personal bankruptcies of small business owners whose enterprises have failed. It can be difficult to separate the individual from the company, when personal credit cards are the first source of venture capital and garages, attics, and dorm rooms serve as the company headquarters. The new bankruptcy law will make things far tougher for hundreds of thousands of small businesses, something entrepreneurs are likely to take into account when they consider whether to take the plunge. [Michelle J. White](#), an economist at the University of California, San Diego, found that states with higher homestead exemptions - which allow bankruptcy filers to keep some amount of home equity after filing - had much higher rates of business ownership. Her conclusion: Entrepreneurs take bankruptcy, and the degree to which they are likely to be punished for failure, into account.

That is logical. Entrepreneurs have to evaluate a wide array of possible outcomes, and one of these is the worst-case scenario, the failure of the company. The bankruptcy debate focuses so much on lower-income groups - and correctly so from a social justice standpoint - that the business side is ignored. When discussed at all, it's usually to debate the justice of big, old concerns like the auto parts manufacturer [Delphi slashing wages](#).

With the bar raised for personal bankruptcy, and particularly the costs associated with failure, fewer people may decide to start businesses. Instead of losing almost everything but being able to start anew, would-be business owners now must spend up to five years living on a system of allowances developed by the Internal Revenue Service.

[Professor White writes in an article](#) that this "would make the U.S. small business environment more like that of Germany, where bankruptcy law has never included a "fresh start," risk taking is frowned upon, there are many fewer entrepreneurs, unemployment is higher and economic growth is slower."

IV. Driving the Poor Out of the System

The changes to the law affecting the poorer half of the population appear modest, but seemingly little changes can do a lot of damage to those on the economic edge. Poor debtors will have to pay for mandatory credit counseling and furnish more pay stubs and tax returns. Lawyers now have to certify their filings and assess their average incomes over the previous months, which in turn is leading to higher fees.

The upshot is that bankruptcy is becoming more of a hassle and more expensive. One Harlem native waiting in line in downtown Manhattan on that wet October afternoon said she was shocked at the price tag. "I couldn't go to a lawyer," said the woman, who preferred that her name not be used. "I tried that first and it was \$790. There was no way I could afford that." With the help of the low-cost filing service "[We the People](#)," she managed to get it done for just over \$500, including court fees. She was embarrassed to admit that she had to borrow much of the money from her sister and a friend. Being too poor to declare bankruptcy sounds like the ultimate Catch-22, but it can be a reality for people in economic distress - and it is likely to become far more common under the new law, which hikes the costs of bankruptcy considerably.

The answer for many people who are too poor to be bankrupt is what academics call "informal bankruptcy." "If you erect barriers, more people will opt not to file," says [Lawrence Ausubel](#), a University of Maryland economics professor who

has studied the phenomenon. Rather than pay the high costs of a formal bankruptcy, poor people may choose to hang up on creditors when they call, change their phone numbers, and even change addresses. [In a study he co-authored](#), Mr. Ausubel found that half of the delinquent accounts written off by credit card companies were from debtors who had not filed for bankruptcy.

Worse still is what can happen after that. To avoid having their wages garnished, debtors may begin to turn away from mainstream financial institutions and credit arrangements. They may turn to the sort of high-cost payday loans and check-cashing outlets that some illegal immigrants rely on, and work for cash-only businesses. That hurts them by driving up their cost of borrowing money and limiting their employment options. It also hurts the wider economy, because it means they stop paying taxes.

V. A Blow to Consumer Spending

A final likely result of the new bankruptcy law is that many consumers may do what has become unthinkable: stop spending. If small businesses are important for the economy, consumer spending is absolutely essential.

While proponents of creditor-friendly bankruptcy laws harangue consumers for living beyond their means, economists say that exuberant consumer spending is crucial if the American economy is going to keep growing at its current pace. For manufacturers and service providers to continue to thrive, consumers have to keep buying what they are offering up.

Americans have shown a strong, and ever-growing, commitment to spending: average household credit card balances have risen to over \$9,000. A change in the bankruptcy law alone is not enough to change these consumer spending patterns. But the

new bankruptcy law is not an isolated occurrence. It comes at a time when a number of forces are all working against consumer spending. This winter, the combination of these forces may finally break the back of United States demand.

The rapid rise in real estate values over the past few years has been an important factor in driving up consumer spending. The "wealth effect" of soaring property values has given Americans the confidence, and in many cases the home equity loans, to spend on consumer goods. There are signs, however, that the real estate market is finally beginning to cool, which means that home equity as a [cost-free ATM for homeowners](#) may be about to stop.

At the same time, consumers are facing an array of fast-rising expenses. [Health care costs are skyrocketing](#), with employee shares of deductibles and premiums increasing far faster than in the past. Gasoline prices have jumped and home heating costs are expected to soar this winter. Americans who make less than the median income already [spend well over 10% of their budgets on energy](#), according to [Economy.com](#). That percentage is likely to rise sharply in the days ahead.

Perhaps most significant of all is an expensive but little-noticed rule change by the nation's banking regulators, who decided back in January 2003 [to require credit card companies to ask for higher minimum payments](#). The change was intended to ensure that customers paying the minimum would eventually pay off their full balance and get out of debt. It's a great rule that happens to be hitting at exactly the wrong moment. Some banks have already made the switch, but between now and January 1, more and more customers carrying high balances on their cards will see their minimum payment requirements double.

With consumers under financial pressure from so

many directions, we could have expected a surge in bankruptcies. [Credit-card delinquencies reached a record of 4.81 percent](#) of accounts in the second quarter - and that was before Hurricane Katrina hit and drove prices up.

(Sidebar: "[A Bankruptcy Lawyer Visits the Gulf](#)")

It is clear that the new bankruptcy law will, as critics have long argued, make the lives of debtors far worse. It's not as clear how severe the effect on economic growth will be. But consumer spending adjusted for inflation fell in September for the second month in a row. That's the first time that's happened in 15 years. Instead of a White Christmas, we may - thanks in part to the new bankruptcy rules - have one deep in the red.

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